

THE IMPORTANCE OF FINANCIAL SYSTEMS FOR DEVELOPMENT: IMPLICATIONS FOR EGYPT

Gerard Caprio, Jr.
Stijn Claessens

DISTINGUISHED LECTURE SERIES 6

A PUBLICATION OF
THE EGYPTIAN CENTER FOR ECONOMIC STUDIES

CONTENTS

تقديم

هل تطور قطاع التمويل هام للتنمية الاقتصادية؟ وما هى الصعوبات التى تواجه العديد من الدول النامية فى إصلاح نظمها المالية؟ وماذا يعنى هذا كله بالنسبة لمصر؟ محاولة الإجابة على مثل هذه الأسئلة ليست بالأمر الهين كما يعتقد البعض. فهناك من الاقتصاديين، من وزن روبرت لوكاس الحائز على جائزة نوبل فى الاقتصاد، من اعتبر العلاقة بين التمويل والتنمية مبالغ فيها. ومما يزيد الأمور تعقيدا أن بعض الحكومات تقف مكتوفة الأيدى حتى تفشل بعض البنوك وتتعرض للانهيار، ويحدث هذا حتى فى دول متقدمة مثل الولايات المتحدة الأمريكية. وأخيراً ومع التسليم بالتقدم الملحوظ فى القطاع المالى المصرى إلا أن جهودا أكبر يجب بذلها حتى يلبى هذا القطاع الحيوى احتياجات النمو فى الاقتصاد الحقيقى.

فى هذا الإصدار يقوم "جيرى كابريو" و"ستين كلاسينس" بتقديم إجابات مقنعة على الأسئلة المطروحة أعلاه اعتمادا على الاطروحات النظرية والخبرات الدولية. وبشكل أكثر تحديدا يشرح الكاتبان لماذا وكيف تساعد القطاعات المالية فى عملية النمو الاقتصادى، حيث تقوم هذه القطاعات بتعيين وتوظيف الموارد المالية، وتوفير أوعية إدخارية وتيسير إدارة المخاطر وتحسين أساليب تنظيم المؤسسات الاقتصادية وتوفير وسائل الدفع وتسوية المعاملات. واستنادا إلى ما هو متوفر من بيانات يؤكد الكاتبان على أن أسواق الأوراق المالية ليست مكانا للمقامرة وأن القطاع المصرفى ليس مجرد مكان لإيداع الأموال.

ولشرح ما قد يعترض عملية إصلاح القطاع المالى يقوم الكاتبان بتحديد ما يرياه كمشكلات مشتركة تواجها الدولة النامية، مثل الأوضاع السياسية والمؤسسية غير المواكبة والمصاعب القائمة فى سبيل الرقابة والإشراف ووجود أزمات مالية حادة. وبدون التقليل من أهمية مثل هذه الصعوبات، يشرح الكاتبان كيف قامت بعض الدول بإصلاح قطاعاتها المالية بنجاح مشهود مثل شيلى.

وبمقارنة مصر بتجارب الإصلاح الناجحة يشير كابريو وكلاسينس إلى مدى الحاجة إلى تخفيض سيطرة البنوك المملوكة للدولة وتحسين منظومة الحوافز وتدعيم الدور الاشرافى والرقابى للبنك المركزى. وقد استثارت هذه المحاضرة مناقشات هامة لمواضيع حرجة تمس وضع القطاع المالى فى مصر وتطوره، مثل التأمين على الودائع وتشرذم القطاع المصرفى ودور صناديق الاستثمار وخطورة استمرار الإقراض للمشروعات المدينة التى لا يؤمل فى إصلاحها. وقد كانت إجابات جيرالد كابريو على هذه الاستفسارات بالإضافة إلى المحاضرة نفسها، إسهاما قيما للحوار الدائر حول حاجة القطاع المالى فى مصر إلى الإصلاح وكيفية القيام به.

د. أحمد جلال
المدير التنفيذى ومدير البحوث
أبريل ١٩٩٧

FOREWORD

Does finance matter to economic development? If so, why do so many developing countries find it difficult to reform their financial systems? Finally, what does all this mean for Egypt? The answers to these questions are less than obvious. Some distinguished economists such as Robert Lucas term the relationship between finance and development as "overstressed". Governments wait until banks fail, even in such developed economies as the United States, and despite notable progress, the financial system in Egypt has yet to develop sufficiently to cope with the growing needs of the real economy.

In this publication, Jerry Caprio and Stijn Claessens provide convincing answers to these questions. Building on theory and international evidence, they show how and why efficient financial systems help economic growth—they mobilize and allocate resources, provide savings instruments, facilitate risk management, improve corporate governance, and provide means of payment. The authors cite evidence to support the view that equity markets are more than a casino, and the banking sector is more than a place to deposit money.

On the difficulties of financial system reform, common problem areas among developing economies are identified, such as adverse political and institutional conditions, obstacles to regulatory and supervisory reforms, and initiating reform under crises. Notwithstanding these difficulties, the authors show how some countries—e.g. Chile, Malaysia—were able to successfully reform their financial systems.

In comparing Egypt to successful reformers, Caprio and Claessens highlight the need to reduce domination by state banks, improve the incentive environment, and strengthen the supervisory role of the central bank. After presenting the paper at ECES, Caprio responded to participants' questions about deposit insurance, evergreening policy, bank fragmentation, liability, and mutual funds. The discussion constituted a valuable contribution to the debate on why Egypt's financial system needs reforming, and how to go about it.

Ahmed Galal
Executive Director and Director of Research, ECES
April 1997

About the Speaker

GERARD CAPRIO, JR.

Lead Economist, the World Bank Policy Research Department

Gerard Caprio is a leading authority in the field of financial reform in transitional and developing economies. Currently, as Lead Economist in the Policy Research Department at the World Bank, Dr. Caprio directs the Bank's research in this area, and heads advisory missions to various developing countries.

Caprio's experience spans the public and private spheres on both the national and multinational levels. He began his professional career at the International Monetary Fund. He later served as an economist in International Finance at the Board of Governors of the US Federal Reserve System. Before joining the World Bank in 1988, Caprio was Head of Global Economics at JP Morgan. He also taught graduate-level international economics at George Washington University for several years.

Caprio has published extensively on monetary policy and financial sector reforms, including the IMF-World Bank publication *Building Sound Finance in Emerging Market Economies*. He is currently researching bank insolvency and the role of credit in developing countries. He is a member of the American Economics Association, and contributes to several esteemed economic and financial periodicals.

PART I
THE IMPORTANCE OF THE FINANCIAL SYSTEM FOR DEVELOPMENT: IMPLICATIONS FOR EGYPT

"Money...is a machine for doing quickly and commodiously, what would be done, though less quickly and commodiously, without it; and like many other kinds of machinery, it exerts a distinct and independent influence of its own only when it gets out of order." John Stuart Mill

1. Introduction

From shell money to the most sophisticated financial systems of today, financial markets and instruments become more extensive and diversified as development progresses. However, unlike the steel industry, which produces a reasonably well-defined set of products, the financial sector produces an amorphous bundle of services that often are not appreciated. As suggested by the above quote, it is easy, except in times of crisis, to ignore the role of money and finance. Partly as a result of this neglect, government often has regarded the financial system as a tool for implementing its own policies—influencing resource allocation, income distribution, and growth. And with the exception of a few notable economists, such as Schumpeter, the economics profession largely ignored or de-emphasized the role of finance, based on the assumption, as Joan Robinson (1952) put it, that ".. where industry leads, finance follows." More recently, Robert Lucas (1988) termed the relationship between financial and economic development "overstressed."[1]

Gradually, during the 1955-73 period, and subsequently at an accelerating pace, economists and policy makers have been according far greater importance to finance in the development process. This brief paper explains why.[2] The paper has three goals: first, to review why finance matters for economic development and to present evidence that it is indeed important for growth;

[1] The authors gratefully acknowledge comments from Ahmed Galal and Mahmoud Mohieldin. They also thank Ross Levine for the above quotations. The findings, interpretations and conclusions expressed herein ae entirely those of the authors and do not represent the views of the World Bank or other institutions.

[2] For elaboration of the themes and evidence presented here, see some of the references listed for further reading.

second, to discuss why financial reform is so difficult; and third, to address some of the implications for Egypt.

The next section quickly reviews the channels through which finance is thought to influence growth, and how finance operates; we then turn to a review of the evidence. A combination of cross-country evidence, industry and firm level data, and case studies strongly argues that development of financial markets and institutions plays a critical role in economic development. However, financial sector development has proved to be difficult in many countries, including Egypt. Section 4 discusses why in general this has been the case. On several indicators the Egyptian financial system appears to be reasonably developed relative to its per capita GDP, but the last section highlights some of its shortcomings compared with 'world class' standards, and challenges for its further development. Making these improvements will help raise economic growth, according to the evidence presented in Section 3. Moreover, growing integration with Europe means that the nonfinancial sector in Egypt will increasingly demand first-rate financial services, or will go elsewhere to get them. How to provide these services, without incurring undue risks for taxpayers, is addressed below.

2. What Does the Financial System Do?

The Functions of A Financial System

The financial system provides a variety of services to businesses, households, and the government. Financial intermediaries:

- mobilize funds
- provide saving instruments
- facilitate the trading, hedging, pooling, and diversifying of a variety of risks
- allocate resources
- exert corporate governance
- provide payments and other services.[3]

[3] This decomposition of the functions of finance is taken from Levine (1997), and the discussion in the ensuing three paragraphs borrows heavily from that piece.

These functions are of key importance; individual borrowers and lenders cannot costlessly come together, sign and enforce contracts governing the exchange of money now for the promise to pay in the future, assess credit risk, monitor investments, or obtain other financial services. By pooling savings, intermediaries give savers and societies access to larger, and likely more productive, investment possibilities, and allow for a wider range of savings instruments and other financial services. Intermediaries and the markets they support—such as interbank, money, bond, and equity markets—enhance liquidity, that is, the ability to exchange easily some assets for others. Savers often prefer not to part with their funds for a long time for a variety of reasons. But without liquid markets, savers will more likely prefer the security of more liquid, and usually low return, projects to more illiquid but higher return ones; for if a negative shock hits them after the investment choice is made, the absence of liquid markets will be particularly disadvantageous to those making the latter choice. Indeed, early in development, this is precisely what savers do; higher return investments often are shunned both because they require a sizable commitment of resources and also because they would increase the already substantial risks confronting residents there. The more liquid markets are, the more savers will be induced to hold a bundle of assets diversified along the risk and maturity spectrum.

Part of the risk to savers arises, first, because it is costly to trade claims on assets, and second, because they usually know less about how funds will be used and the likelihood of their return than do investors (which is termed 'information asymmetry'). Intermediaries help on both counts. Banks provide savers with liquidity by offering demandable debt and term savings, both of which regularly are of shorter maturity than the underlying investments, whereas equity markets allow claims on investments to be easily traded; thus both reduce transaction costs. They also uncover information about underlying investments: banks, in the course of their lending decisions and equity markets, by revealing the value of firms. These functions are particularly important: Sir John Hicks has argued that improvements in financial market liquidity were the primary causes of the industrial revolution in England. Although many of the inventions had been in existence for a while, they required large commitments of long-term capital. In effect, then, Hicks argued that the industrial revolution had to wait for the financial revolution.

The services financial intermediaries offer can be especially important for small- and medium-size enterprises. These often do not have retained earnings and lack access to preferential finance. The entrepreneur who tries out new ideas needs credit—as Schumpeter has put it, "He can only become an entrepreneur by previously becoming a debtor"—and a financial system with a broad set of instruments can help. The services the financial system offers are not limited to traditional credits or loans. Leasing a truck, for example, may be the way for a small enterprise to get started; improving cash management may help a recently established firm; and providing insurance for legal liability claims can help an enterprise operating in an otherwise too-risky market. The breadth of the services a financial system offers also matters for savings. Through the various savings instruments it offers, the financial system broadens the saving choice, which in turn leads to a rise in saving and investment.

In addition to the trading of risk and pooling of resources, financial intermediaries allocate them, meaning that they assess firms and projects, monitor their investments, and often as part of this process play a role in corporate governance. These roles—allocation of resources and corporate governance—take place through lending decisions and in many countries by equity as well. Financial intermediaries offer a variety of debt, equity, and mixed contracts with the goal of maximizing the return to themselves (and repaying their depositors and creditors). In doing so, they as outsiders contrive with a firm's inside owners to induce the firm's managers to behave in the best interests of the owners and outside creditors. Small, outside owners cannot monitor and verify the performance of firm managers efficiently on their own, hence the demand for intermediaries. The means by which intermediaries exert control over users of funds differ. Banks, which typically offer short- and long-term financing, can discipline managers by not renewing loans. Liquid equity markets reveal the market's valuation of how a firm is doing and so determine its costs of new capital. Through changes in valuation, equity markets play an important role in corporate governance—with the final threat of management replacement or takeover should a firm's value slip too low.

Decisions about how to allocate and use resources are important for growth; even in economies with large capital inflows, tiny increments in the efficiency with which domestic resources are used can dwarf the effects of these inflows. Improving the marginal efficiency of capital in a typical developing country with a capital-to-output ratio between 2 and 3 by 1%

would yield greater gains than if net capital transfers to the average developing country were all in grants. Raising the rate of return on capital in China, for example, by one percentage point would have more impact than doubling the net capital transfers it received in 1995. Utilizing domestic resources efficiently is, of course, even more important for countries with no significant access to foreign sources of capital. Economizing on the costs of providing these key functions is an important reason for the existence of intermediaries, and there is evidence (Section 3) that more developed financial systems allocate resources to more efficient uses and thereby lead to more rapid economic growth. Since intermediaries will look not just for better current uses of resources but also for better future uses, they will encourage innovation, another channel to promote faster growth.

The most quoted function of finance—providing payment services, in particular, the unit of account, means of payment, and store of value functions of money—is the role of finance most taken for granted. But it is also key. By looking at early societies, such as those command societies with no money, it is easy to appreciate the gains from trade without resort to barter. Life without finance—such as in some traditional societies—in this sense can be difficult, as noted in Box 1. These societies arrange a number of substitutes: barter to take the place of payments services, children for long-term saving and insurance, multiple income earners for casualty insurance, rotating savings and credit associations for formal savings institutions. But such substitutes can entail a number of inefficiencies, as suggested by their more common occurrence mainly in lower-income countries.

The problems of life without finance are not just an intellectual curiosity, but become apparent when modern societies seriously impair the functions of financial systems. This breakdown is dramatically manifested in times of hyperinflation.

> "Take a banana,' says Italo Gasparini, director of the Brazilian Central Bank's Currency Department. 'What does it cost? One hundred cruzados. Is that cheap or expensive? I don't know. Do you know?"
> *Wall Street Journal*, December 1988.

As inflation accelerates, so does the search for alternative units of account, media of exchange, and stores of value. Physical commodities often take on some of the functions of money; barter trade, with all its inefficiencies, returns; and residents allocate significant efforts to getting rid of money before it loses its value. These 'financial engineering' activities crowd out the other important functions of finance, thus it is not by chance that real growth typically slows or halts during hyperinflation.[4]

Financial sector development has also often been hamstrung by government policies. The prevailing attitude in the 1950s—and even more recently in many countries—was that finance did not matter. This, coupled with underdeveloped revenue systems, led governments to use financial intermediaries as a vehicle for collecting taxes. Reserve and liquidity requirements were high, deposit interest rates were kept low, credit was allocated in accordance with government plans, and profits were channeled to the fiscal authority. Although the resulting breakdown of the functions of finance were not as noticed as in the case of hyperinflation, there typically was a substantial underinvestment in human and information capital, the brains of financial systems, and often perverse incentives in the (usually) few intermediaries. These incentives ranged from those of an employment agency, a cheerleader for the planning bureau in the credit allocation process, to growth for its own sake. Providing valued services for private sector clients often received little attention, and the quality of lending suffered as a result of the perverse incentives, including those resulting from extensive ownership links between banks and enterprises. It also has led in many countries to constituencies having strong interest in preserving the status quo, which makes financial development difficult and political economy issues complex.

This perverse impact on the institutional development of the financial system has also contributed to the large number of banking crises in recent years, as negative shocks hit a banking system already suffering from a poor regulatory framework and bad management. The crises brought to light the quasi-fiscal costs which had been building up through the use of the financial system as a piggy bank and distributor of funds to further socio-economic objects. In

[4] "Especially in the latter stages of inflation, investment in durable goods took on a bizarre aspect. Little effort was made to distinguish between ...plant and equipment as would justify, in future yield, the present outlay and those which would merely prevent the complete evanescence of ... monetary value; ...when monetary stability was restored ... much of the apparatus installed [in 1920-1923] was scrapped." F.D. Graham, *Exchange, Prices, and Production in Hyperinflation: Germany, 1920-23,* p.323.

response, many countries have reconsidered the role of the government in the allocation of resources—to remove distortions and free up fiscal resources—and realized the need for independent institutions.

Box 2.1 Life without money*

"Some years since, Mademoiselle Zelie, a singer .....gave a concert in the Society Islands .... in exchange for a third part of the receipts. When counted, her share was found to consist of three pigs, 23 turkeys, 44 chickens, 5000 cocoa nuts, besides considerable quantities of bananas, lemons and oranges .....as Mademoiselle could not consume any considerable portion of the receipts herself, it became necessary in the meantime to feed the pigs and poultry with the fruit."
W.S. Jevons
Money and the Mechanism of Exchange
(Jevons 1898, p.1)

Even in modern economies many transactions do not involve money. For example, barter is used to escape taxation and regulation. In developing countries, most exchanges within extended families are handled without cash. The multiple incomes of an extended family offer a substitute for insurance, pension plans, and so-called security. In many areas of the world, share-cropping involves a series of nonmonetary transactions concerning inputs, land tenure, crop sales, and so on. In some countries neighbors help one another to build their houses without payment (*gotong royong* in Java, barn raising in the United States).

The economy of ancient Egypt operated for 2,000 years before the intervention of money (although precious metals served as a medium of exchange for some transactions). Even after several surrounding states adopted coinage, the government of Egypt opposed the use of money. The Inca Empire of Peru may not have used money as a medium of exchange, despite being exceptionally rich in gold and silver. Some religious societies (including the almost self-sufficient Jesuit Republic of Paraguay in the sixteenth and seventeenth centuries) and authoritarian or paternalistic communities (such as the large *haciendas* of Latin America) make little or no use of money, at least for internal transactions.

Nonmonetary transactions tend to be aspects of a long-standing social compact, whose individual parts cannot be valued separately. But in advanced economies most exchanges are impersonal. As Mademoiselle Zelie discovered, trade can be quite costly without a widely accepted medium of exchange.

* This box was originally developed for the 1989 World Development Report

How the Financial System Works

Across the world, financial systems have evolved in quite different ways and, while there has been some convergence in recent years, there are still substantial differences. Some countries have systems dominated by banks; for example, in Germany and Japan, bank assets represent over 85% of all financial intermediary assets, and banks exert considerable influence on firms. Other countries, for example, the United States and the United Kingdom, rely much more on capital markets for firms' financing and governance (these have been called "market-based" systems). These differences in financial systems have evolved in response to a host of specific economic, legal, cultural, historical and political factors, some quite idiosyncratic in nature.[5] The importance of finance as a direct contributor to the economy also greatly varies; in countries such as Luxembourg, finance contributes about 15% of GDP, while the average for OECD-countries is about 3%. But it should be clear that the real contribution of finance goes beyond its share in GDP.

Yet, in spite of the often quite marked differences between financial systems over long periods of time, it has proven very difficult to “rank” the different financial systems in use now or in recent history, in terms of their impact on the economy, even in stable developed countries.[6] While there are many theoretical arguments and some case histories, there is, for example, little available evidence on the relative performance of bank versus market-based systems. This does not mean there are no commonalities among countries with successful financial systems; well-functioning financial systems are almost all characterized by a stable macroeconomic environment, including positive real interest rates for depositors and creditors, a reasonably well-functioning legal system, an adequate supply of human skills, developed auditing and accounting skills and standards, limited government interference in credit allocation, and a proper and transparent regulatory, supervisory and enforcement framework, in addition to a competitive enterprise sector—because good firms are essential for good banks.

---

[5] The German bank-based system, for example, is thought to have been importantly influenced by a tax provision which allowed citizens to avoid a withholding tax if they deposited their equity claims with banks; since this resulted in banks controlling these shares through proxy votes, banks had a greater influence in firm governance.

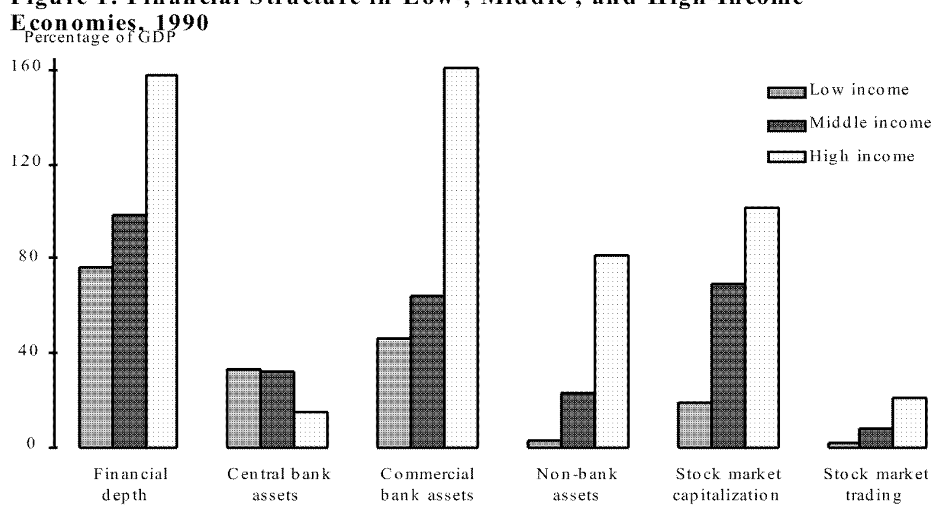
[6] See, among others, Allen and Gale 1995, Walter 1993, and Saunders and Walter 1994.

In addition, there has been much commonality in this process of financial development. As seen in Figure 1, as countries develop,

- financial intermediation deepens;
- banks grow relative to central banks in allocating credit;
- nonbanks rise in importance; and
- stock markets become more liquid.

Low income countries are characterized by reliance on informal finance: lending for small investments secured through a network of social relationships and peer group monitoring, which often is linked to trading and agriculture and mainly involves advances for trade from one firm to another.

Figure 1: Financial Structure in Low-, Middle-, and High-Income Economies, 1990



Source: R. Levine

Notes: The data of Figure 1 are for 12 low-income countries, 22 middle-income countries and 14 high-income countries. Financial depth is measured by currency held outside financial institutions plus demand deposits and interest-bearing liabilities of banks and nonbank financial institutions (M3 money supply). Nonbank assets include insurance companies, pension funds, mutual funds, brokerage houses and investment banks.

Foreign banks may play a large role in financing foreign trade, but much less so in domestic trade. As the economy develops and urbanizes, some of these networks may formalize themselves into neighborhood lending associations or banks. This process of more formal financial intermediation is often accelerated when there are major new developments in the economy, for example, opening up of new trading opportunities or new industrial discoveries, which generates concentrated wealth. During most of this process, financial intermediation will be dominated by banks. Capital markets will only come to play a role in the later stages of development, when legal systems and reputational capital are established and people have the trust to trade pieces of papers which just represent promises to pay. While progression from one stage to another stage can be hastened, it is not clear that actual stages can be skipped. For example, it has seldom been the case that countries have been able to develop their equity markets without having reasonably developed short-term money markets, for if the infrastructure for trading relatively low-risk instruments is lacking, riskier products such as long-term bonds and equity are generally absent.

This pattern of financial development at the macro country-level mirrors in many ways the financial life cycle of a typical firm. A firm may start as a family-owned business, using the family's own resources, as well as savings collected through a network of social contacts. It will then typically grow mainly from its retained earnings and funding from its suppliers. At some point, when it has established a sufficient business record, it may be able to get a loan—often only on a highly secured basis—from a local bank. As it grows and expands its relationships, it will typically be able to attract funds from a wider circle of financial intermediaries, including other banks, venture capital and leasing companies. Over time, it may be able to go to the capital markets, first most likely to the private placements markets and later to organized, publicly traded bond and equity markets. This process can be hastened, such as by improving the accuracy and reliability of information, reducing the costs of contract enforcement, and encouraging greater transparency. Also, reducing uncertainty at the macro level, such as by encouraging governments to maintain credible and consistent policies, and at the micro level, by developing more stable industry regulation, will encourage the evolution of firms along this ‘life cycle’ of how they are financed. Encouraging this development should be an important goal of the governments.

Recent Global Trends[7]

Around the world, the financial system in general and banking in particular have gone through important structural changes in the last decade for a number of reasons. First, domestic deregulation and financial services liberalization have resulted in increased competition, which has weakened profitability and asset quality of banks in many countries. Many countries witnessed major bank failures or banking crises, in part as a result of these forces, but also due to the institutional decay or lack of development which characterized the periods of heavy government intervention. These banking crises have in some cases resulted in a thorough restructuring of banks and a return to profitability, but in others large segments of the banking systems remain insolvent. Second, technological advances in communications and information systems have enhanced the capacity of banks and other financial market participants to use the opportunities offered by the liberalized environment. Technological developments have eroded barriers between parts of the financial system and between countries. New information systems allowed the creation and use of highly complex new financial products. Technological advances and the progressive elimination of official barriers to capital flows have spurred an enormous increase in cross-border financial transactions and activities and rapid growth in international financial markets. As a result, linkages among financial markets have been greatly strengthened and financial conditions in individual countries have become increasingly sensitive to developments in external markets.

These structural trends, which are more advanced in higher income countries but also evident in middle income members, have had important consequences for the functioning of the banking sector and the financial services industry more generally.

1. There has been a gradual erosion of the distinction between various types of financial assets. In particular, "money" has clearly become much less distinguishable from other liabilities of financial intermediaries.

2. The demarcation lines between the different types of financial intermediaries have become increasingly blurred. An important consequence is increased competition

[7] This section draws heavily on Blommestein, 1995.

among categories of institutions which were formerly not direct competitors. More intense competition and the attendant reshaping of financial institutions' strategies have strengthened the trends towards financial conglomeration. Specialized institutions have often disappeared.

3. The volume and average size of financial transactions have grown spectacularly. This has put higher demands on the stability and efficiency of clearing and settlement systems for payments.

4. Securities market activity has gained ground relative to traditional bank lending. In particular, large corporate borrowers have used the securities markets for an increasing share of their external financing requirements. Particularly, in part as a result of the privatization of state enterprises, equity markets have expanded dramatically.

5. Off-balance-sheet activities of banks have become significant, in particular the use of derivatives as well as the emphasis put on proprietary trading and asset management. In addition, assets tend to be removed from the balance sheet of the originating institution, for example, through mortgage backed securities. This has changed the balance sheet and revenue structure of banks.

6. Off-balance-sheet business has created stronger linkages between the various sectors of the financial services industry. The size of these interlinks is very difficult to measure. This makes it increasingly difficult to assess the direct credit, liquidity and interest rate risks of individual banks.

7. Against a backdrop of lower profit margins and loss of traditional business, banks have sought entry into new lines of business, and many of them became more active in riskier (and supposedly more profitable) segments of credit markets. The resulting "financial fragility" of the banks makes them more vulnerable to adverse shocks. In a

number of countries, authorities had to rescue banks (or other depository institutions) at taxpayers' expense.

8. There has been a structural change in the sources of funding, especially deposits versus money-market instruments. The shift of bank funding sources varied among countries, but deposits have grown more slowly than assets of institutional investors (insurance companies, collective investment or pension funds); this has had implications for the banks' funding. Greater shares of total financial intermediation will probably take place through the capital markets, and banks will have to adjust their funding strategies accordingly.

These important trends in recent years have led to some convergence in financial systems across the world. In banking, in a number of countries the norm has become for financial institutions to form large groups that offer a full range of financial services (i.e., banking, securities, leasing, etc.), usually performed in a separate subsidiary. Countries now having such an institutional structure include the United Kingdom, France, Italy and Spain. Japan has authorized banks and securities houses to expand into each others' primary line of business. Although the United States continues to maintain the legal separation between banking and securities, banks and securities firms are active in offering close substitutes for each others' products; banks' securities powers have been extended significantly in the 1990s, and further extensions are expected.

At the same time, in countries with universal banking systems, institutions are moving toward international practices. Some major German corporations, for example, are modifying disclosure practices to conform to international practice. Deregulation, internationalization and increased competition have thus led to a narrowing of differences among financial systems, particularly a greater reliance on capital markets than in the past. This has meant a declining role of banks in traditional areas, but an expanding role in others. What is actually occurring is not a contraction in banking per se, but a switch of banks from on-balance to off-balance-sheet activities, and an increasing involvement of banks in the capital markets. Over the next decade, these trends are expected to become more evident in many low- and middle-income countries.

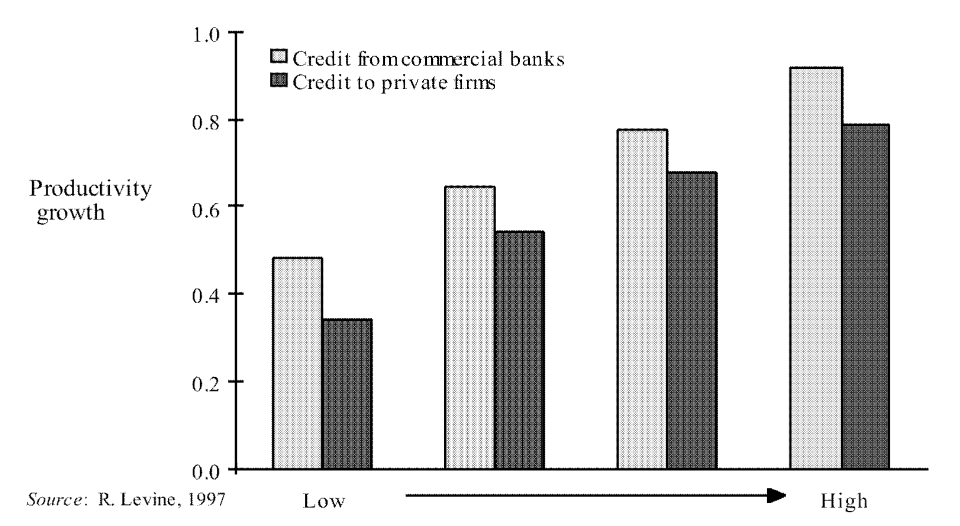
3. Does Finance Matter?

The previous section has highlighted the powerful arguments as to why finance matters. This section turns to more systematic evidence pertaining to the role of finance in development. Comparative case studies have documented the links between financial and economic development. These studies range from a spirited debate on the role of banks in explaining different growth rates of Scotland, England, Germany and France in the 18th and 19th centuries, to the role of finance for US railroads and other infrastructure in the 19th century, to the role of finance in Japan's pre- and post-war success, and to that of intermediaries in igniting Korea's growth in the early 1960s. The evidence strongly suggests that financial deepening—increases in the ratio of broad money (currency plus checking, savings, and time deposits) to GDP—almost always accompanies economic growth. More formal early empirical studies on the role of finance were confined to investigating links between real interest rates and savings. Several studies found little or no significant relationship, and concluded that finance does not matter. But as elaborated above, finance is about more than just interest rates; recent studies demonstrate that the links between finance and growth are important.

One seminal piece of this research (King and Levine, 1993) uses a cross-country sample of 80 cases over the period 1960-89 and shows clear and convincing links between growth and finance, and also strong evidence that better developed finance *precedes* faster growth (Figure 2). After controlling for a variety of other factors (income, education, political stability, and measures of monetary, fiscal, trade and exchange rate policies) that affect growth, this study finds that there is a statistically significant link between both the extent to which commercial banks allocate credit and the tendency of the financial system to lend to private firms, on the one hand, and real per capita GDP growth on the other. Financial systems in which commercial bank credit was small compared with central bank credit tend to be those in which governments intervene with large-scale directed credit programs. The significance of more credit being extended to private firms is that this likely coincides with banks performing their credit assessment, monitoring, and corporate governance functions, as well as doing a better job of

providing efficient payment systems, compared with what would be provided if governments and state-owned enterprises (SOEs) were the main clients.

Figure 2: Productivity Growth in Developing Countries, 1960-89



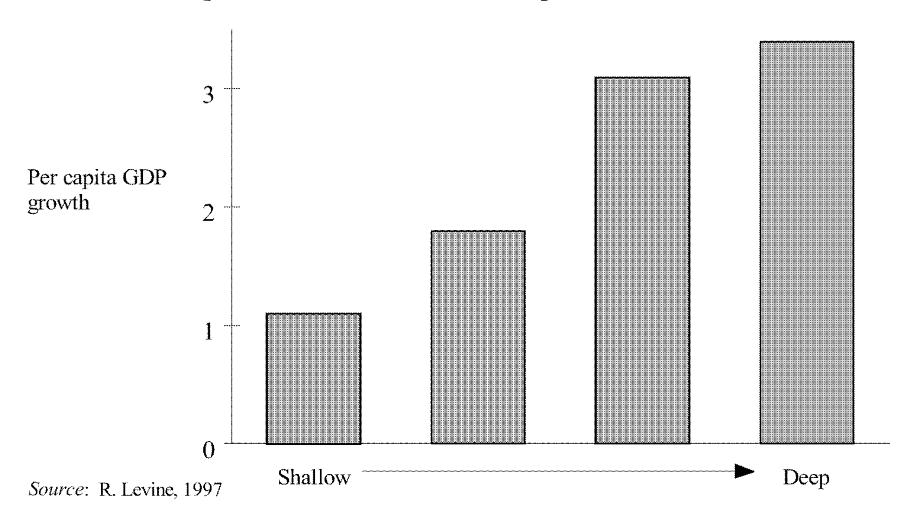
Source: R. Levine, 1997

Notes: Figure 2 has classified 80 developing and developed countries in four groups according to the share of credit from commercial banks (and credit to private firms) relative to GDP. On the vertical axis is the unexplained residual (or productivity growth) over the 1960-89 period from a standard cross-country growth regression on initial income level and human capital, subsequent investment ratios, and other factors (political stability, and measures of monetary, fiscal, trade and exchange rate policies) that affect growth.

Although it is possible that more developed economies lead to better financial systems, the same authors go further and find that those with deeper financial systems in 1960 saw faster growth over the subsequent 30 years (Figure 3). Not only does this research mean that the relationship between finance and growth cannot solely be due to faster growth-inducing financial sector development, but also that the effect of financial sector development on economic growth is significant. For example, if Zaire in 1970 had increased its share of domestic credit allocated by banks from only 26% of total credit to the average for developing countries in that year (57%), it would have grown about 0.9% faster *per annum.* Greater

financial sector development was found to raise growth both by increasing capital accumulation and—importantly—by raising productivity.

Figure 3: Growth and Financial Depth, 1960-89

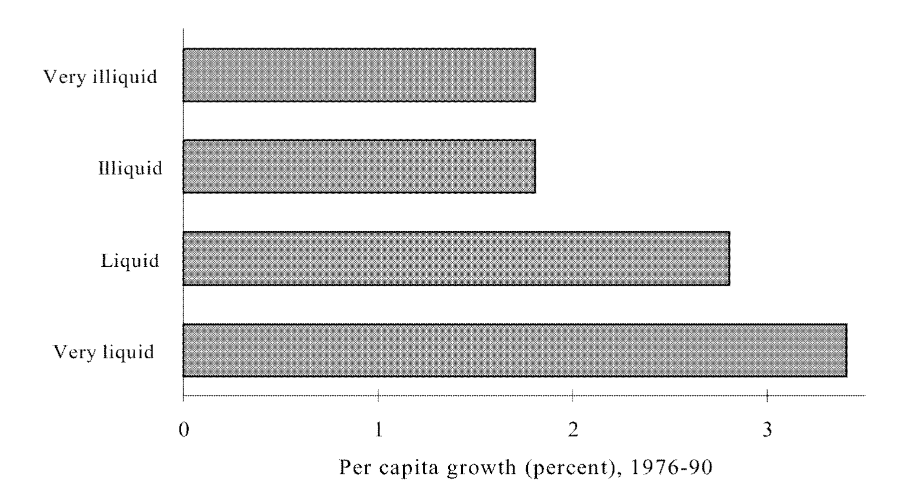


Source: R. Levine, 1997

Notes: Figure 3 has classified 80 developing and developed countries in fourgroups according to the ratio of broad money (M2) to GDP in 1960. On the vertical axis is the per capita growth rate over the 196089 period.

As explained above, banks are not the only important part of a healthy financial system. Equity markets, often thought to be a casino, have been found to exert an independent effect on growth. As seen in Figure 4, of 38 countries with the requisite stock market data in the 1976-94 period, those with highly liquid equity markets initially saw more rapid growth over the subsequent 18 years. This measure of liquidity likely captures the ease of trading equities, and shows a significant relationship with growth. Having liquid stock markets and more developed banks led to the most rapid growth rates seen in this group of countries (Figure 5). It is also quite relevant for policy makers that banking and stock markets independently influence growth, and appear to be complements throughout most stages of development. This complementarity likely arises because both debt and equity finance induce better accounting, auditing, and the formation of a cadre of trained finance professionals. It is only as countries reach the per capita income levels of OECD countries that further stock market development seems to induce a decline in firms' debt-equity ratios.

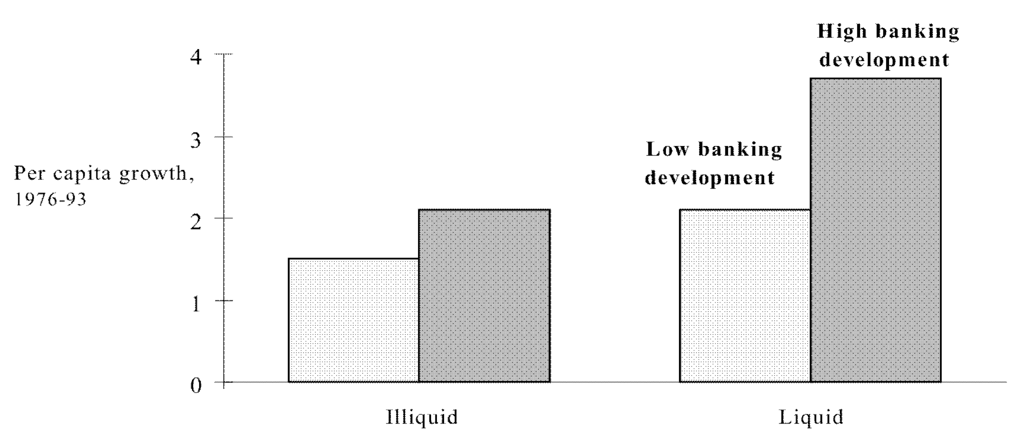
Figure 4: Initial Stock Market Liquidity and Long-run Growth



Source: R. Levine, 1997.
Notes: Figure 4 has classified 38 developing and developed countries in four groups according to their stock market liquidity (turnover relative to GDP) in 1976. On the vertical axis is the per capita growth rate over the 1976-90 period.

In addition to findings based on large cross-country data sets, there is also evidence from looking at how finance is allocated among firms before and after financial reforms take place. According to the seminal study in this area (Chapter 4 in Caprio et. al., 1994), following financial reforms in Ecuador and Indonesia in the 1980s, there was an increased tendency for finance to be allocated to more efficient firms after reforms than before. In other words, with less intervention in credit allocation and pricing, intermediaries were more likely to allocate capital where it would be best used, thereby raising economic growth. Interestingly, in the Indonesian case it was also true that financial reforms led to more credit for smaller firms, which previously had been more constrained in obtaining funding. This type of adjustment has been found in other countries, and even more so in transition economies: enterprise studies clearly show that financial (and other) reforms lead to much improved resource allocation.

Figure 5: Growth and Initial Stock Market and Bank Development



Source: Demirgüç-Kunt and Levine, 1996.

Notes: Figure 5 has classified 38 developing and developed countries in two groups according to their stock market liquidity (turnover relative to market capitalization and turnover relative to GDP) in 1976. These two groups are then subdivided into four subgroups according to the ratio of bank loans to private enterprises to GDP, also in 1976. On the vertical axis is the per capita growth rate over the 1976-93 period.

Additionally, a firm-level study for 30 countries (Demirgüç-Kunt and Maksimovic, 1996) shows that ability to enter into long-term contracts and stock market liquidity both have a positive impact on firm growth, confirming the importance of finance from more aggregate studies. Thus, case studies, firm-level investigations, and cross-country research all confirm a key role for finance. Moreover, the studies of reforming economies also suggest that financial sector development can be altered by policy.

4. Reforming Finance

Why is Financial Reform so Difficult?

If finance is important for growth, then it is crucial that countries 'get it right.' Many countries, however, for long periods heavily controlled their financial systems; reform was thus necessary. Financial reform programs differ markedly depending on the stage of development, but usually include measures aimed at reducing or eliminating the government's intervention in the determination of interest rates, as well as decreasing its role in credit decisions. They also

may include measures to increase the degree of competition of markets, allow foreign entry, rehabilitate or restructure banks, create or repair financial infrastructure—auditing and accounting, and contract enforcement mechanisms, including the legal system—and deepen markets. Yet financial reform often has been followed by financial crisis.[8] Why has reform been so difficult?

First, the performance of economies following a period of financial reform depends on the initial conditions—how underdeveloped the financial system was prior to reform. Countries do not begin the reform process with a successful financial system that is performing well its intermediary functions. Instead, they often start after a substantial period during which the government was intervening in financial markets in allocating and pricing credit (often to unprofitable ventures) and often in a variety of other ways that encouraged little or no investment in the skills required in a market-based system. If governments are allocating credit, then banks have no incentive to invest in the many skills they will need in a market environment, nor to acquire the information and information systems they will need to monitor their risks. When post-reform crises occur, then, they may merely reveal the pre-existing weaknesses, rather than constitute evidence that reform is ill-advised.

A key initial condition concerns the adequacy of information and the ability to enforce contracts. Yet information often will be particularly poor and unreliable, due in part to the absence of accounting and auditing standards and skills, and disclosure will be limited at best. Moreover, the pre-reform legal system often will be based on a 'rule of state law' rather than on a 'rule of law state,' and changing from the former to the latter will demand some time. In this situation, intermediaries will tend to lend to those with whom they have built up a relationship; viable banks will tend to engage in 'safe' loans to connected parties and, where the government pays on time, to hold government securities. Two disparate post-reform adjustments have been seen: one in which credit growth, after a period of repression, grows explosively, and another in which the banks become more risk averse. The differences in this pattern of adjustment relate to a number of incentive and institutional differences.

---

[8] For an early recognition of the problem, see Diaz-Alejandro (1985). Caprio and Klingebiel (1996,b) review banking crises in developing countries.

In addition to basic weaknesses in the financial sector, an important component of the initial conditions concerns the role of vested interests. In countries in which a relatively small group of individuals, families, or conglomerates controls financial intermediaries and uses them to fund its own activities, there will be clear and well-organized opposition to changes that threaten their preferred position. Such groups routinely are supporters of powerful political figures. In these situations, developing a picture of the financial sector will be more difficult, as disclosure will be limited and supervision weak. Reform is not doomed, however, but will necessitate an aligning of groups interested in greater openness and competition in finance, in funding non-family ventures or small- and medium-scale enterprises (SMEs), etc. Cheaper communication and computing make cross-border competition in financial services of growing relevance in developing countries and will impose limits on attempts by local banks to stifle reform; still, the information advantage of local firms will give domestic banks some natural protection from this competitive threat.

As with other types of reform, it is important, in judging the likelihood that reform will be successful, to look for three 'readiness' conditions: the extent to which reforms are politically desirable (to the leadership and supporters), politically feasible, and credible (World Bank, 1996). When all three conditions are met, significant reform is likely.

Financial crises may offer opportunities to commence more fundamental reform, to the extent that they lead to a shift in the disposition and influence of various groups towards reform, and thereby affect these three conditions. For example, in the 1970s, Chile began the easy liberalization steps of deregulation and allowing private entry, while proceeding more slowly on building infrastructure and creating an incentive compatible regulatory system. When large losses in the banking sector in the 1980s could no longer be hidden, thanks to the sharp reverse of capital flows, the political will to take harder measures was found, and much greater reliance on market oversight, coupled with a significantly strengthened and more independent supervisory capacity, was instituted. Interestingly, in Malaysia the relatively independent central bank became a locus of pressure for continuing gradual reform and independent supervision, and the payoff to this approach appeared to foster the creation of a coalition backing reform. This gradual process continued after a significant but relatively small banking sector crisis in the mid-1980s.

Second, financial reforms often have created a dangerous gap: liberalization with bad regulatory and supervisory systems. Countries have liberalized interest rates, credit controls, and international capital flows, but regularly did not upgrade institutions, such as accounting and reporting standards, the legal system, or the incentive system that was facing bankers, nor were significant attempts to develop human capital in the financial sector common. This particular sequence should not be surprising: liberalizing measures are inexpensive, fast, and easy to implement, while the institution building is expensive, slow, and complex.

Not surprisingly, many countries did the cheap, fast and easy reforms first. However justified the sequence may have been on political grounds, and though it did lead to demand for better infrastructure for finance, it was often dangerous for the stability of the financial system. Once banks encountered a solvency problem, many corrective efforts mainly fixed the balance sheet but were less effective in correcting the underlying conditions that led to the problems. These corrective efforts often led to moral hazard and created perverse incentives.

Third, timing often was bad, in that it coincided with other negative shocks that weakened banks. A variety of macro shocks, including for many developing countries wide swings in their terms of trade, have made sound banking challenging even where institutions are more conducive to its practice. Countries that tended to move faster with reforms during good times and slower during bad times—such as Malaysia and Korea—appear to have been more easily able to deal with the inevitable adjustment costs of moving from a highly controlled financial regime to one based more on market forces. Malaysian authorities, even when macro shocks forced them partially to reverse more visible aspects of financial reforms, continued to develop the institutional framework needed for successful bank and nonbank development, and now enjoy one of the deepest financial systems in the world and rapid growth.

There have been several types of responses by governments in the face of banking crises. The first—said to be common with those informed about their impending demise—is denial: the problem is never thought to be as bad as the fears of outside experts, yet in practice the losses often are far larger than any early estimate, not least because this period of denial inevitably allows the losses to grow. Second, some governments have adopted cures that in effect mask the problem and lead to other distortions, or tackle only the visible issues, without addressing fundamental causes. For example, in some countries where it was judged that banks

were in trouble because large borrowers could not repay, these borrowers were given monopoly privileges in their output market or favored access to foreign exchange or imports, so that they could repay loans.

A second popular cure is to allow banks to earn wider spreads—control deposit rates at low levels to recapitalize themselves. The difficulty is that if none of the conditions which led to the granting of bad loans is corrected, the temporarily cured banks often will continue to make bad loans. Both of these solutions entail, for whatever reason, regulatory forbearance: leaving banks on their own to work themselves out of their difficulties.

The problem with this solution is that the incentives which permitted or accommodated the growth of bad loans are allowed to persist. Thus, in Chile in the early 1980s, the United States in the later part of that decade, and in Japan more recently, it took several years before the authorities took steps to address the incentive system. In all of these cases, closing banks and forcing owners to take losses were an integral part of the cure, designed to send the message that failure will be costly.

Features of More Successful Reform

What would be a better way to reform finance? There is good reason, based on a study of financial history,[9] to believe that sound banking will flourish when there is good governance or oversight of banks, as well as the possibility and incentive for banks to diversify, so that they can withstand sizable shocks. The candidates for serving as monitors of banks are owners, the market, and supervisors, and although many suggest that it is important to strengthen one of these groups, research gives us no clear sole party to be responsible for safe and sound banking. In fact, in many countries it is important to strengthen all three, and more successful reform cases—Chile, Malaysia, the United States—have taken significant steps to do so. Owners (and senior managers) need to have clear incentives and the capacity to monitor their institutions, as they are the first line of defense against unsound banking. They also have the ability, no matter how skilled the supervisors—witness the Barings crisis—to hide the extent of losses either deliberately or due to weak internal governance. Hence it is crucial to make sure

[9] See Caprio and Vittas, 1997, for an overview of financial history and the lessons for emerging market countries today.

that owners have a lot at stake, either of their present capital, namely through high capital requirements, personal wealth (higher liability limits) or future profits (high franchise value for bank licenses). Well-motivated owners will strive to make sure that their institutions are run efficiently, as long as they have a significant amount at stake.

Even the best motivated owners have a difficult job controlling their institutions, and this is where outsiders can contribute. The market, meaning those with a current or potential claim on the bank, such as (uninsured) creditors or depositors, as well as participants in interbank markets, can signal when a bank is having difficulty, such as by raising the cost of funds. In order to do this, besides having resources at risk (hence the importance of being uninsured), market participants require reliable information, meaning that disclosure laws need to be clear and provide stiff penalties for their neglect. When government safety nets do not interfere or limit the losses suffered by these market claimants, they can be quite effective. For example, in the wake of the Mexican crisis of late 1994, depositors at some Argentine provincial banks, not protected by deposit insurance, began a run on weak banks, but a good part of their funds went to some of the strong, well-capitalized money center banks. More generally, although systemic bank crises can occur, selective runs on particular banks are more the norm, meaning that the market does have some ability to distinguish between different types of institutions.

Bank supervisors also can be an ally of motivated owners. Governments, unless they can convince the public that they will not cover depositor losses, have a responsibility to taxpayers to supervise banks so as to minimize claims on them. Although some bank owners view supervision as a nuisance, good supervision can highlight unsafe practices and also serve, along with internal auditors, to discourage bank fraud. Governments also are responsible for regulating banks, that is, determining the rules within which bankers must operate. If regulations are incentive compatible, meaning that they encourage prudent banking, then supervision will be commensurably easier—owners, being properly motivated, will act prudently and will also recognize the value of proper supervision.

Lastly, even with an otherwise incentive-compatible regulatory framework, banks can get into trouble if they are forced or encouraged to concentrate their risks. Banks in small economies with capital controls are forced to hold a local portfolio that usually features highly covariant risks. For example, unless incentives are astonishingly effective, banks invested only

in Chile will suffer when copper prices decline, as will domestic banks in Rwanda or other economies dominated by a few commodities. In such economies, only foreign banks or local banks with significant foreign exposure will be able to survive commodity price swings unless capital, liability limits, or franchise value are sufficiently high to compensate for the risk associated with greater loan concentration.

In sum, early attention to what can be called the 'four pillars' of a sound financial system—the incentives and capacity for owners, the market, and supervisors, and the incentives and capacity to diversify—are crucial. Reform programs that strengthen these four pillars as soon as possible have a greater likelihood both of remaining free of banking crises as well as enjoying better quality financial services and faster growth.

5. The Challenge for Egypt

In view of the move to closer competition with Europe, Egyptian firms require first-rate financial services and a cost of capital that is competitive with its northern neighbors. This means a banking system that is safe and sound, and able to mobilize resources and allocate them efficiently, as well as to provide the type of financial services that individuals and firms demand. The authorities also are dedicated to raising growth, particularly the anemic savings rate, which has been far below that of successful economies in East Asia (Page, 1996). Given this outline for more successful financial reform, how does Egypt compare?

Egypt embarked on the first stage of financial reform beginning in the early 1990s with a move to market-determined interest rates, adoption of Basle capital adequacy guidelines, and a more modern asset classification system (Bahaa-Eldin and Mohieldin, 1997). The government also has reduced its visible interference with the allocation of credit, though it still has a significant program for cotton financing. Both of these moves were common to a number of developing economies, though many of them saw banking sector problems.

One key advantage that Egypt enjoys is that it has been able to attract a number of good foreign banks, which not only helps provide better diversification for the entire banking system, but also acts as a catalyst for training bankers and introducing competition. A second advantage is the development of stock markets: in the last several years, both the capitalization of listed firms and the volume of trading has exploded (Shams-El-Din, 1997). Given that a few

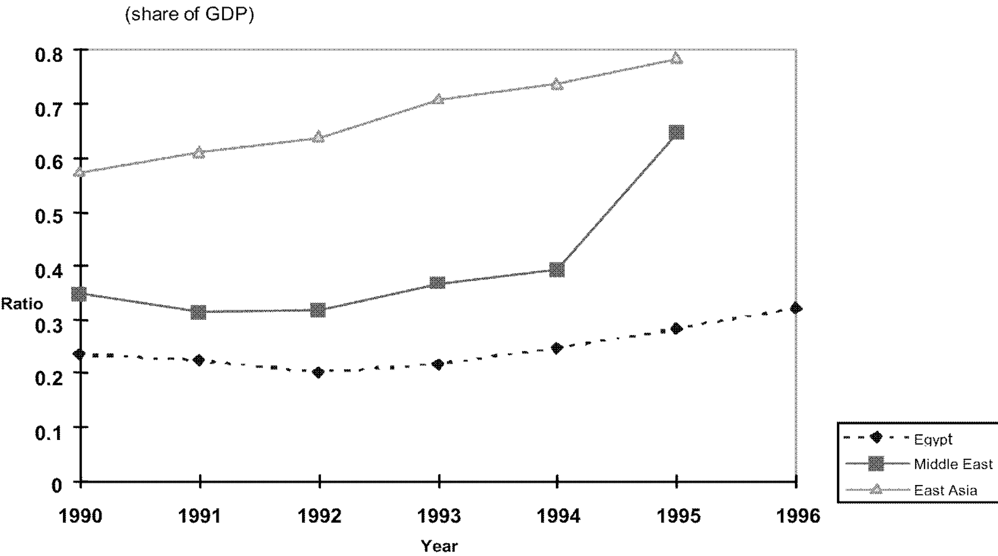
countries, such as the United States and Korea, were able, for very different reasons, to rely relatively more on nonbanks as an important part of the financial sector, the benefit of deepening equity markets is important.

Notwithstanding these considerable achievements, in many respects Egypt's financial system shares the limitations that plague a number of emerging market or transitional countries. Most dramatically, about 70% of bank assets are controlled by state-owned banks. It is difficult to find countries with such a high degree of state control and a successful, innovative banking system. Indeed, in many cases of state ownership, the state does not effectively perform its ownership function and instead uses state banks to satisfy a variety of purposes, most often to increase employment. Hence many state banking systems suffer overstaffing, and the services that are provided are neither cost effective nor up to the competition from private banks**.** Although Egyptian banks could be the exception to this rule, the last such exception, the French state-owned banking system, saw record losses in Credit Lyonnais and no longer is cited as a model.

Looking at more successful economies, among the rapidly growing economies of East Asia, state banking is relatively limited, except in Indonesia, where it has declined significantly from about 80% of banking assets in 1988 to less than 50% at present. Also, when banks are predominantly state-owned, the deregulation of interest rates is unclear; although they are determined in a 'market,' the state's role remains significant. In other countries, deregulating interest rates with large state ownership merely has meant that interest rate setting has moved from one part of the government to another.

Moreover, the Egyptian banking system's support of the private sector has been quite limited. As seen in Figure 6, the amount of credit to the private sector lags even within the Middle East region (indeed, some transitional economies such as Poland and Romania are allocating a larger share of resources to the private sector). King and Levine (1993) found that countries in which banking systems devoted a smaller share of resources to the private sector saw lower growth in comparison with countries devoting more to this sector. This deficiency of the Egyptian system can be viewed as a problem, an opportunity (in the sense of a hidden potential of the economy) or both.

Figure 6. Credit to the Private Sector
(share of GDP)



Source: The World Bank.

An additional concern is the incentive system in which the banks operate. Owners' and managers' incentives to engage in safe and sound banking have been strengthened in many countries by allowing banks to fail and making sure that owners lose their equity and bankers their jobs. The dominance of the government in Egypt, coupled with a 'no exit' policy, makes it exceptionally difficult for incentives to operate effectively. Although we lack any direct evidence on bank efficiency—which is difficult to gather even in high-income economies—the combination of state ownership and lack of exit raises concern about the efficiency of financial intermediation by the banking sector.

Also in common with many developing countries is the weakness of the second pillar, the oversight provided by the market, likely the weakest pillar in Egypt. As in many developing countries, disclosure laws are relatively weak (Bahaa-Eldin and Mohieldin, 1997), auditing is significantly underdeveloped, and rating agencies not present. Thus it is extremely difficult for

outsiders to understand the condition of Egyptian banks. Although this may mean that the judgments of the last paragraph are too pessimistic—the banks may be in good shape—it more likely means that Egyptian banks, without effective market oversight and with owners not focused on profits as the bottom line, are at least not providing efficient financial services.

With the first two pillars being weak, if not compared with many developing countries then at least with what is needed for better banking, it is important that supervision be especially strong. However, although it is difficult to evaluate supervision, the exceptionally low pay (according to those in government as well as those in the banking industry) makes it difficult to attract and retain competent staff in the central bank, the agency charged with both monetary policy and bank supervision. Also, the number of supervisors has failed to keep pace with the expansion of the number of banks and branches. Perhaps most important, the independence of the Central Bank of Egypt is limited, statutorily, and its governor serves at the discretion of the President and Prime Minister (Bahaa-Eldin and Mohieldin, 1997). Many countries have moved in the direction of establishing fixed and reasonably long terms (4-8 years) for central bank governors to allow some insulation of monetary policy and supervisory actions.

Upgrading supervision in Egypt must start with following best practice (in Europe, the United States, and advanced developing countries) in terms of the independence of the central bank and by compensating central bank staff at levels above those of the rest of the government, reflecting their higher market value. Keeping supervisory salaries low risks major losses in the banking sector, which better supervision can help to minimize. Bank supervision also is hindered by the weaknesses of the other two pillars—owners are not favorably disposed to supervisors, and information is of dubious reliability. Thus, developing all three simultaneously can make an important contribution to a better financial system and, as suggested earlier, raise economic growth.

The last pillar, better diversification, appears to be less of an issue for Egypt, not only because the economy has achieved modest diversification itself, but greatly due to the presence of foreign and joint venture banks. As noted, the presence of good foreign institutions may help

offset some of the aforementioned disadvantages. A relatively well-developed stock market, by providing alternatives to debt finance and increasing the demand for improvements in the infrastructure supporting finance, lends to the system a more solid foundation than might otherwise be the case.

In sum, the challenge for Egypt is to use the current favorable climate as a time to strengthen these pillars, both to reduce the unfavorable impact on banks of some future economic downturn and to plant the seeds for a more dynamic financial system and faster growth in the future. Although there is no one clear path to financial sector development, the required direction, that of strengthening the role of owners, the market, and supervisors to oversee banking, is evident. Moving more of the banking sector into private hands will likely lead to greater lending to the private sector. Ensuring that private owners and managers of banks are motivated to conduct safe and sound banking will increase the efficiency of resource allocation. The evidence cited earlier corroborates the importance of finance, and offers hope that sustained financial sector development will speed the course of economic growth, and help Egypt become a true 'Middle East Miracle' country.

PART II: DISCUSSION
TOWARDS A BETTER FINANCIAL SYSTEM IN EGYPT

Participants in the discussion following Caprio's presentation included: Ali Negm, Adel El Labban, Sameh Makram Ebeid and Faika El Rifaei from banking, Taher Helmy, Mohamed L. Mansour and Gamal El Nazer from the private sector, and Gouda Abdel Khalek and Mahmoud Mohieldin from academia. The following is a summary of the discussion.

Participant: I have two questions regarding the role of banks in development in a situation like Egypt's. First, you spoke of the importance of increasing the liability of owners and shareholders to improve risk management in banks. What do you think of the implicit policy in certain countries that bank failure should not be allowed?

The second question is related to the fragmentation which exists in the banking system in Egypt, especially in the private sector. How does this fragmentation affect the ability of banks to grow, to invest in human capital, to raise sufficient capital, and to compete, against both the private joint venture and the larger state-owned banks? Is fragmentation a positive or a negative for the economy? How can creating small banks in rural areas away from a metropolis affect the banking system and growth?

Speaker: I cannot overemphasize the need to allow exit from the banking industry as part of moving to a better incentive environment. In the nonfinancial sector of a market economy, when a firm gets into trouble, it gets cut off from credit. Owners step in to try to restructure the firm if it remains viable in its ongoing activity. When large businesses get into trouble, they usually do survive, but in a smaller form. They have to downsize to their profitable core activities and get rid of unprofitable activities. This involves lay-offs and always includes management change, sending a very clear message that failure is costly. When the government gets involved, it disturbs that process, and the signal is short-circuited. I see no reason why the banking sector should be protected from this important signal. That's one reason why the transition economies are changing. Their system, which cut off that signal completely, did not work. In some countries, that exit signal was not allowed to occur for bad banking. But even in

Japan, where they were very opposed to bank exit, they now allow banks to fail. It is crucial for a better incentive environment.

There has not been much study on fragmentation and growth. But the most fragmented banking systems are those where fragmentation is caused by the government. When the government gets out of the way, fragmentation is usually reduced. If the banking system is excessively fragmented, one should ask what the state is doing about it. If there is large state ownership, that is usually the most important thing. If 70 percent of your bank assets are in state-owned banks, that's one reason why the remainder stays fragmented and cannot grow. It is important to shrink state ownership of banks in order to have a more efficient banking system.

Participant: What do you mean by human capital in relation to banking? How could it affect the performance of banks?

Speaker: What I meant is the skills and knowledge possessed by bankers. In some of the transitional countries—for example, during an early World Bank mission to Romania—we were trying to take inventory of their institutions, and we asked bankers what kind of risk management process they had. Their response was: What is risk? They had never incurred risk before because the government took care of everything. So they had not invested much in developing the skills to make credit decisions or asset-liability choices. Those types of skills are important for bankers and bank employees to possess.

Let me give you an example to illustrate how human capital can affect bank performance. In Chile in the mid-1970s, the authorities deregulated the banking system, allowed the market to work, liberated interest rates and gave the responsibility to bankers. But for at least the four to five preceding decades, those banks had not been responsible for their credit decisions. So they had no skills, and they made a variety of mistakes. That was a major reason for their problems and the crisis of the 1980s. We see this problem a lot in low-income countries.

Participant: I would like you to comment on the quality and the liquidity of bank assets, and how both affect the performance of the bank.

Speaker: That's a good question. On liquidity I talked about allocation of the balance sheet between short and long term instruments. Asset quality, and especially capital quality, are

extremely important. Recent studies found that US banks' capital did not predict bank failure very well. It was only marginally useful in predicting bank failure. The problem is that while there may be data on the quantity of capital, there is little data on its quality. In some countries that were privatizing their banks, the banks were sold at prices that seem high. But the buyers borrowed the capital, sometimes from the same banks they were acquiring, which made the quality of the capital very poor.

Participant: On incentives and higher liability, you mentioned that in some countries there is double liability, which goes against the basic principles of corporate law in any country. Which countries have done so? Is this an exception for banks, and how do they do it? To what extent are owners involved in day-to-day bank management?

Speaker: The country where it is most clearly the exception for banks is New Zealand, where it has been developed for a relatively restricted set of cases. First of all, they established it so that the banks have to disclose quite a lot of information. They also got the government out of bank supervision. When the bankers disclose information to the supervisors, they must also disclose to the public. If the information is erroneous or anything important is omitted, bank owners face unlimited liability. It is too soon in my view to make a conclusion, and we don't know how high the liability should be. There hasn't been a lot of experience in modern times with high enforced liabilities.

Let me give you another example of ways to increase liability without changing the law. In Germany, when a bank fails, the central bank and finance ministry invite all the main bankers and creditors of the failed institution, and they ask the executives: Why did you fail? They already know the reasons—the point they are trying to make to those individuals is that they will never get a job in the financial industry again. In the US, some executives who headed failed banks move to another state and become bankers again. It is a very different incentive environment. I think this is one of the many reasons why there are more bank failures in the US than in Germany.

The extent to which owners are routinely involved in management of the banks varies from bank to bank, country to country. I think liability and consequences for both managers and owners is very important. However, there haven't been many studies to reveal what is the

optimal form of liability. I think you all agree that if you raise liabilities too high, this might lead to bankers becoming too risk averse, and they would not have an effective role in the economy because they would not underwrite enough growth. But what if you take the opposite extreme, which in developing countries is that they should all adapt to the BIS capital adequacy guidelines? In my view this limit is too low. When industrial countries were developing, their banks held 25 to 50% capital-asset ratios. It would be hard to believe that many developing countries are safer environments now than Germany was in 1900. That high capital level was not a regulatory phenomenon, it was because of incentives. There was no safety net under the banks, and therefore customers wouldn't put their money in banks unless they were run very prudently. You cannot apply one recommendation to everyone, but we do know what doesn't work. In the US we have already taken the position that 8% is too low for banks, and now 10% is the minimum, and there is discussion among economists of raising it further.

Participant: What are the criteria for successful, sound banks and banking systems?

Speaker: There are a lot of possible answers, but the most important line of defense is that formed by the bank owners and managers. It is important for banks to have high franchise value. Banks like Morgan and Deutsche Bank are extremely prudent because their franchise is worth a lot to them. They have great clients and the ability to adapt to the changing financial markets, which keeps them extremely profitable. So they are worth a lot to their owners and managers. When bankers look around for models of which risk management they should adopt, they look at Morgan and Deutsche Bank. Having this franchise value is key.

You could have too much competition in banking and let anyone enter the banking system. In Russia there are probably 3000 institutions called banks, and many are believed to be of doubtful solvency—some are outright Ponzi schemes. There is no control over entry, so a bank license is not worth much. But there are a few institutions that have created their niche—their franchise—and these banks are thought to behave prudently. Having an environment where a bank franchise is worth a lot is important.

Many people think that the US and Japanese banking systems had problems because they offered deposit insurance which led to a lot of risk taking. In the USA in the 1950's and 60's, after deposit insurance had been around for years, there were several recessions, and

macroeconomic conditions were not very good, but banks didn't fail very much. One reason they didn't was that they were constrained, entry was limited and they had a very high franchise value. When competition came in, it took away a lot of profitable responsibilities. Some banks saw their franchise going down, so they began to take greater risks and got into more trouble.

Clearly there are a lot of variables for having sound banks. I emphasize the importance of a good information environment. I am often accused of saying that the real sector is just a veil of the financial sector and the financial sector is more important than the real sector. But the real sector does matter. If you reform the banking sector and ignore the rest of the economy, you will still have problems. The best banking system in the world will have problems if the economy is unstable and you ignore it. You can't concentrate on the banking system alone.

Participant: My first question is on 'evergreening' policy. Do you disapprove entirely of such policy or would you allow it in some cases? We have used it in Egypt very successfully, and it helped banks to improve their loan portfolios and balance sheets.

You advise Egypt to improve its financial sector by establishing mutual funds. We do have about 16 mutual funds in Egypt now. Should these funds operate through bank departments or as completely separate entities? Also, how important is deposit insurance? International institutions and consultants often ask why we don't have deposit insurance in Egypt. Finally, do you think the merger of small and medium sized banks can help strengthen the banking system?

Speaker: It may at times seem useful to give clients more time, which may involve giving them more money. But in a market economy, banks cannot give clients more money without demanding that the clients change, if they want a positive result. The term evergreening is meant for when banks give clients more money, and nothing else is done. That is always going to be a negative. They may want to work to turn some clients around.

One US bank, now called Nations Bank, was expanding and took over a failed bank in Texas. It set up a department to collect on written-off loans. With all the bank failures in the US, this department became a separate subsidiary because it had so much business. It now has a portfolio of $25-30 billion. They found that of 150 cases where parent banks had written off

their client loans, only 1.5% merited giving the clients more time. In the other cases, it would only result in bigger losses. So evergreening should be used very sparingly.

It is sometimes argued that it is better to have mutual funds separate from banks so that bankers are not competing with themselves. I don't agree, however. In many countries, depositors want the certainty of a fixed rate of interest on a bank account. But when they reach a certain level of wealth, clients want to take more risk, and a well-motivated banker will want to offer it. It may be good to allow both banks and non-banks to run mutual funds and develop the industry. Who runs mutual funds is less important than other conditions of the economic environment. Mutual funds engage in equity business, which needs a lot of information, good disclosure, and good accounting.

Views on deposit insurance are divided. My own view is that a safety net leads to excessive risk taking. Yet it is hard to do away with it entirely. If depositors want certainty and you do away with it, they will go elsewhere if they can. But guarantees should be as limited as possible.

The World Bank is now embarking on a study of the relationship between deposit insurance and bank failure. It is too early for conclusions, but there is some evidence that the likelihood of having a banking crisis is greater with explicit deposit insurance. To whatever extent the government is involved in offering either implicit or explicit deposit insurance schemes, it has to pay attention to supervision, because taxpayers' resources will be at risk.

In the UK there is deposit insurance, but it is called coinsurance, in the sense that all bank depositors have 20 or 25 % of their deposits uninsured. Some people argue that this system is very successful and losses have been very low. But the UK banking system is very concentrated and banks have a lot of franchise value. So that gives the owners an incentive to pay attention to these institutions. We do know that private deposit insurance does not work, because it is impossible to price deposit insurance if you cannot limit the risks that banks take. When there is explicit deposit insurance, it is necessary to limit the risks banks take, which creates a role for some type of government supervision, because if the government is involved in bailing out banks, it has to be involved in regulation as well.

I have little evidence on bank mergers. It takes a long time after a merger for a bank to become a cohesive whole, and it depends on the environment. I have seen mergers that work

well. But if two weak banks merge, they could form one large bank that may not be a stronger one.

Participant: I think the issue is not whether finance matters—it does matter, hence the question is what is its proper place in the overall composition of the economy, in countries in general and in particular. I think the thrust of what you are saying is that financial reform is a must, and liberalization is a big component of reform. But you presented material to argue for the importance of financial reform, of a relation between financial depth and economic growth, and financial depth and productivity. In which direction does causality run—from financial depth to growth and productivity, or are we talking about variables that just happen to be correlated?

Finally, it seems to me that the questions 'does finance matter' and 'does finance cause growth' are different. In the Egyptian case, what would be the role of macroeconomic factors in the failure of the financial system? Sometimes you can have a combination of an exchange rate, a balance of payments position, and monetary and fiscal policy that provide a very unstable situation waiting for a trigger to cause a financial crisis.

Speaker: It would be unwise, for instance, to deregulate interest rates without some degree of macroeconomic stability, a solvent banking sector that is reasonably contestable and competitive, and bankers with basic banking skills (some asset liability management skills) so they would know how to price loans. Finance involves more than just the balance sheet. My remarks about the role of finance were especially aimed at the people who doubt how important finance is, including a lot of macroeconomists who don't seem to think it is very important.

Causation is difficult to disentangle. I believe causation goes both ways; a greater rate of growth does lead to more financial deepening, and market-oriented systems will respond to demands from the nonfinancial sector. But causation does go the other way as well, from the financial sector to growth. If the financial sector is constrained from developing, there will be constraints on the country's development.

Both micro and macro factors cause banking crises. There was an influential paper written by two economists, Gavin and Hausman, at the Inter-American Development Bank, that

contained an analogy which a lot of macroeconomists like. The analogy compared a banking crisis to a chain breaking. It's true that a chain breaks at the weakest link, but it's not the weak link necessarily but the tension on the chain that produces breakage. Therefore, unless you can predict which link is going to break first, it doesn't make sense to try to fix individual links; you have to worry about the tension on the chain, the macroeconomic factors.

However, the economist Frank Fedder wrote in 1931 that if you assume that macroeconomic shocks like depressions are economic 'acts of God' which individuals are powerless to plan against, then you would believe that these macro forces cause banking crises. If instead you believe that safety and soundness are important in economic systems, which should be built strong enough to withstand shocks, then bank failure is a management, or incentive, problem.

I believe both views have elements of truth. You don't want a fail-safe banking system, so safe and sound that bankers don't take risks, because growth will be too slow. Indeed, such a system is likely not possible. You also don't want a system where banks fail based on shocks that occur annually. How safe should banks be? I think bankers should have incentives to plan for shocks that occur at least every 5-10 years, not just for those that might occur every few months.

Participant: On causality, we have no theory that suggests that causality runs from finance to growth, or the converse. We basically rely on empirical studies. Causality may be a two-way street. In the case of Egypt, if you try to see the correlation between financial development as measured by financial deepening, you find that there is no significant relation between financial development and economic growth. We have financial deepening at 100-105% as measured by M2/GDP, yet GDP growth fluctuates heavily regardless of the financial sector performance. It seems we need a better proxy for financial development.

The sequence of bank privatization needs more attention. Privatization of banks is not a panacea, as some suggest. Joint venture banks in this country have been successfully privatized, and it is rumored that the four big banks may be offered for privatization. But we haven't done enough to offer these banks even in tranches for sale. We haven't done our homework in financial restructuring or consolidation of the banking system before privatizing. Also, isn't it best to separate bank supervision from government intervention?

It is interesting that you say that one of the countries that has Islamic banking is the United States. Recently, the editor of one of Egypt's leading magazines said we should close our Islamic banks. But even if not from a religious point of view, Islamic-style banking could be a good way of diversifying our products.

Speaker: True, just because institutions don't pay or receive fixed interest does not mean that they can't get into trouble. We have seen in other countries Islamic banks that were insolvent. But one should learn the constraints that keep institutions from developing more; mutual funds—a Western-style Islamic bank—will arise where information is plentiful and reliable.

I agree with your view about financial depth. At the Bank we currently have a proposal before the research committee to try to extend those variables and have a whole host of indicators of financial system development, and to look for tendencies for, say, bank-based vs. market-based systems to perform better or worse, etc.

The four pillars don't all have to be in place before starting on the road to privatization, but one should not start instantaneously privatizing before starting to build the pillars. So the strategy of privatizing a couple of banks now and continue privatizing down the road is a good one. In Eastern Europe we have seen countries that said they would privatize banks, but they don't privatize. One apparently more successful case is Poland, which had 13 state-owned banks and a schedule of privatization over a number of years. They are a little behind schedule, but they have privatized four banks thus far. They also changed the incentive system in the current state banks by telling managers that much of their compensation is to be in the form of stock options that they can exercise when the banks are sold. That gives bankers the incentive to do a good job running the banks before they are sold. Experience shows that government restructuring of banks prior to privatization does not have much correlation with the selling price, as governments may not be very good at restructuring. This may argue for selling sooner, not later.

It has been said in the US that the Federal Reserve Board is independent within the government but not independent of the government. Should the supervisory agency be within the central bank or, if separate, should it be independent? I think it has to be independent. We have seen a number of cases where it is not independent, making it easy for government officials with short-term horizons, who are elected every couple of years, to intervene on behalf

of selected constituents for different results; that doesn't work well. In some countries it may be difficult to get one independent institution, namely the central bank, and it may not be politically possible to get more than one. If so, then I would say definitely put supervision with the central bank. Central bankers with authority to supervise banks argue that it is easier for their monetary policy actions to be taken and to be well informed if they have good access to supervisory information. When supervisory information is outside the central bank, the central bank usually doesn't get good information. In some cases, like Germany, where the supervisory agency is not in the central bank, it seems to work, but there again, the whole liability question is quite different.

APPENDIX
LIST OF ATTENDEES

Mona Abul-Kheir
Economist, ECES

Mohamed Gamal El Din El Bayoumi
Assistant to Minister of Foreign Affairs, Egyptian Ministry of Foreign Affairs

Laila Darwish
Program Officer, United Nations Development Program (UNDP), Egypt

Paul Deuster
Associate Director, Office of Economic Analysis and Policy (EAP), USAID Cairo Mission

Mohamed El-Erian
ECES Member, and Deputy Director, Middle East Dept., International Monetary Fund

Hisham Fahmy
ECES Deputy Director & Director of Administration, Finance, & Communication

Mai Farid
Research Analyst, ECES

Samiha Fawzy
Professor of Economics, Cairo University

Nagui El Fayoumi
Special Assistant to Associate Director, Trade & Investment, USAID Cairo Mission

Ahmed Galal
ECES Executive Director and Director of Research

Adel Gazarine
Chairman, The International Office for Engineering Consultancy, Egypt

Samia Guirguis
Assistant Resident Representative, United Nations Development Program (UNDP), Egypt

Ahmed Heikal
Managing Director, Egyptian Financial Group

Taher Helmy
ECES Chairman, and Partner, Baker & McKenzie Law Firm, Egypt

Ibrahim Hussein
Secretary General, Egypt-US Presidents' Council, Egypt

Hala El Khamissi
Research Analyst, ECES

Kamal El-Kheshen
Head of Operations, African Export-Import Bank, Egypt

Samir Korayem
Consultant

Adel El Labban
ECES Board Member and Managing Director, Commercial International Bank, Egypt

Patrice Lord
Editor and Publications Coordinator, ECES

Zeinab Mohamed Lotfy
Deputy Director, Economic Research Department, Central Bank of Egypt

Mirette Mabrouk
Senior Editor, Business Today, *Egypt*

Sameh F. Makram-Ebeid
Financial Consultant, Berliner Bank, Egypt

Farid Mansour
Senior Partner, Farid Mansour & Co. (Coopers & Lybrand International), Egypt

Mohamed Lotfy Mansour
ECES Secretary General; Chairman & CEO Mantrac, and Chairman, Mansour Motor Group, Egypt

Omar Mohanna
Vice Chairman & Managing Director, Egypt Arab African Bank

Mahmoud Mohieldin
Senior Economist, ECES, and Assistant Professor of Economics, Cairo University

Gamal El Nazer
Chairman of the Board, Karoun Investment & Development Co., Egypt

Ali Negm
Chairman, Delta International Bank, Egypt

Khalil Nougaim
Managing Director, Cairo Project & Finance, Egypt

Mohamed Ozalp
Senior General Manager, Misr International Bank, Egypt

Werner Puschra
Resident Representative, Friedrich Ebert Stiftung, Egypt

Faika El Refaei
Sub-Governor, Central Bank of Egypt

Amal Rifaat
Economist, ECES

Thomas Scheben
Director, Konrad Adenauer Foundation, Egypt

Mona Omran El Shafei
Program Officer, USAID Cairo Mission

Ashraf Shams El Din
Deputy Chairman, Egyptian Capital Market Authority

Dina Shawki
Research Analyst, ECES

Ali Soliman
First Undersecretary, Egyptian Ministry of Economy & International Cooperation

Chang-Po Yang
Senior Economist, The World Bank, Cairo

Adel Youssry
Chairman, FINRATE Consulting, Egypt

REFERENCES

Allen, Franklin and Douglas Gale. 1995, "A welfare comparison of intermediaries and financial markets in Germany and the US," *European Economic Review*, 39:179-209.

Bahaa-Eldin, Ziad A., and Mahmoud Mohieldin, 1997. "On prudential regulation in Egypt," presented at the Egyptian Center for Economic Studies conference 'Towards an Efficient Financial Market in Egypt', February 26-27, Cairo.

Blommestein, Hans, J., 1995. *The New Financial Landscape: Forces Shaping the Revolution in Banking, Risk Management and Capital Markets*. Paris: Organization for Economic Cooperation and Development.

Caprio, Gerard, Jr., Izak Atiyas, and James Hanson, 1994. *Financial Reform: Theory and Practice*. New York: Cambridge U. Press.

_______ and Daniela Klingebiel, 1996. "Bank insolvency: bad luck, bad policy, or bad banking," in Michael Bruno and Boris Pleskovic, eds., *Annual Bank Conference on Development Economics,* The World Bank.

_______ and Dimitri Vittas, 1997. *Reforming Finance: A Historical Perspective,* New York: Cambridge U. Press.

Demirgüç-Kunt, A. and Ross Levine, 1996. "Stock markets, corporate finance and economic growth: an overview," *World Bank Economic Review,* vol. 10, No. 2, May, pp. 223-40.

_________ and Maksimovic, 1996. "Financial constraints, uses of funds, and firm growth : an international comparison," Washington, DC: World Bank, Policy Research Dept., Working Paper 1671.

Diaz-Alejandro, Carlos, 1985. "Good-bye financial repression, hello financial crash," *Journal of Development Economics*, Sept.-Oct. 1985, *19*(1/2), pp. 1-24.

King, Robert and Ross Levine, 1993. "Finance and growth: Schumpeter might be right," *Quarterly Journal of Economics*, Aug., *108*(3), pp. 717-38.

Levine, Ross, 1997. "Financial development and economic growth," forthcoming, *Journal of Economic Literature.*

________. "Finance, entrepreneurship, and growth: theory and evidence," *Journal of Monetary Economics*, Dec. 1993, *32*(3), pp. 513-42.

Page, John M. Jr., 1996. "A Middle Eastern Miracle? Development Policy Lessons from East Asia," Egyptian Center for Economic Studies, Distinguished Lecture Series 4.

Saunders, Anthony, and Ingo Walter. 1994. *Universal Banking in the United States*, Oxford University Press: New York.

Shams-El-Din, Ashraf, 1997. "Capital market performance in Egypt: efficiency, pricing, and market-based risk", presented at the Egyptian Center for Economic Studies conference 'Towards an Efficient Financial Market in Egypt', Feb. 26-27, Cairo.

Walter, Ingo, 1993. "The battle of the systems: control of enterprises and the global economy." *Kieler Vorträge* No 122, Institut für Weltwirtschaft an der Universität, Kiel.

World Bank, 1989. *Financial Systems and Development*, World Development Report.

__________, 1996. *Bureaucrats in Business: The Economics and Politics of Government Ownership*, A World Bank Policy Research Report, Oxford University Press.